Franchise Tax Board

SUMMARY ANALYSIS OF AMENDED BILL

Author: Chu | Analyst: Anne Mazur | Bill Number: AB 2344

Related Bills: See Prior Analysis | Telephone: 845-5404 | Amended Date: May 26, 2006

Attorney: Patrick Kusiak | Sponsor: State Controller

SUBJECT: Voluntary Compliance Initiative 2/Underground Economy and Tax Gap

____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended ____________.

____ AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENTS CONCERNS stated in the previous analysis of bill as introduced/amended ____________.

____ FURTHER AMENDMENTS NECESSARY.

____ DEPARTMENT POSITION CHANGED TO ____________.

_X_ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS AMENDED April 6, 2006, STILL APPLIES.

_X_ OTHER – See comments below.

SUMMARY

This bill would require the Franchise Tax Board to develop and administer a second voluntary compliance initiative (VCI 2) for taxpayers that participated in abusive tax shelters.

This bill would also require the Employment Development Department (EDD) to develop and administer an amnesty for payroll tax liabilities. The EDD provisions will not be addressed in this analysis.

SUMMARY OF AMENDMENTS

The May 26, 2006, amendments made the following changes:

- Revised the provision that would require FTB to notify governmental organizations regarding the imposition of penalties against promoters of abusive tax shelters.
- Made various technical changes to correct grammar, references, and other nonsubstantive errors in the bill as amended April 6, 2006.

Board Position:			Legislative Director	Date
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____ N	____ OUA	_X_ PENDING		

- Made substantive and nonsubstantive changes to the provisions of the bill relating to the payroll tax amnesty, which are not addressed in this analysis.

Except with respect to the provision relating to FTB's requirement to notify governmental agencies of penalties imposed on promoters of abusive tax shelters, the April 6, 2006, analysis still applies. Revised "This Bill" and "Program Background" sections of the analysis are provided below to reflect the change in the notification provision made by these amendments.

POSITION

Pending.

ANALYSIS

<u>THIS BILL</u>

This bill, if enacted, would be referred to as the "Underground Economy and Tax Gap Act of 2006." The bill would declare that California "needs to aggressively pursue measures to uncover the underground economy and curtail unethical and illegal tax evasion schemes."

The bill would establish VCI 2 to run from February 1, 2007, through May 15, 2007, for the purpose of motivating taxpayers to file an amended return and pay the correct amount of tax. The bill would also strengthen existing penalty provisions for taxpayers that used abusive tax shelters, in addition to strengthening penalties on the tax shelter promoters and the tax professionals that provided material advice to taxpayers. The material provisions of the proposed VCI 2 are summarized below:

1. A taxpayer that could have participated in the IRS settlement initiative described in Announcement 2005-80 would be prohibited from participating in VCI 2. Thus, a taxpayer involved in a shelter that was not one of the 21 transactions specified by the IRS may participate in VCI 2. Additionally, a taxpayer that is subject to a criminal investigation or that has a criminal complaint filed against him or her would be ineligible to participate in VCI 2.
2. VCI 2 would be offered to taxpayers beginning February 1, 2007, and ending May 15, 2007, for taxable years beginning before January 1, 2006.
3. The taxpayer would be required to file an amended return reporting all income and loss without regard to the abusive tax shelter transaction and pay the tax and interest. The taxpayer would be allowed to request to pay the tax and interest under an installment agreement.
4. The taxpayer would have an elective option under VCI 2:
    - Option A – Voluntary compliance without appeal rights. This option would include waiver of all penalties. The taxpayer's understatement of tax would be subject to a 50% increased interest rate. The taxpayer would <u>not</u> be permitted to file a claim for refund for the amounts paid in connection with potentially abusive tax avoidance transactions.

- Option B – Voluntary compliance with appeal rights. This option would allow waiver of all penalties, except the accuracy related penalty (ARP). The taxpayer's understatement of tax would be subject to an increased interest rate of 50%. The taxpayer may file a claim for refund for the tax and interest paid under VCI 2 after a specified time and the occurrence of certain events. If the taxpayer's claim prevails, a refund with interest would be issued. If the transaction is determined to be abusive, the taxpayer would be liable for the ARP.

5. The reportable transaction-ARP would be modified so that the taxpayer would lose the benefit of the "reasonable cause" exception to the ARP if the taxpayer fails to do any of the following:
    - Participate in VCI 2,
    - Provide basic tax shelter documentation, or
    - Notify FTB of any federal increases to the taxpayer's tax liability with respect to the reportable transaction.

6. Raise the penalty amount for aiding and abetting to $25,000 and $100,000, for individual taxpayers and corporate taxpayers, respectively, from the current $1,000 and $10,000 amounts. The standard for imposing the aiding and abetting penalty would be changed to "should have known" that their actions would lead to an understatement of tax. The current standard is that the aider or abettor "knew or had a reason to believe" their actions would lead to an understatement of tax. This change would place greater responsibility on the tax professional to assure that the correct amount of tax is reported and paid.

7. This bill would increase the normal interest rate charged on underpayments of tax (currently 6%) by 50 percent for participants in VCI 2. Increased interest rates would also apply for nonparticipants:
    - For amended returns filed after the end of VCI 2 and before contact by FTB, double the normal interest rate would apply to tax shelter underpayments reported on such returns.
    - For any other tax shelter underpayment determined after the end of VCI 2, two and one half times the normal interest rate would apply.

8. FTB would be required to notify applicable regulatory organizations, as defined, regarding the assessment of certain promoter-type penalties, if those penalties have become final, with respect to regulated tax professionals. "Applicable regulatory organizations" would include the state bar, accountancy board, or IRS Office of Professional Responsibility with respect to attorneys, CPAs, or enrolled agents, respectively. This bill would also provide an express exception for such notification from the statutes that generally prohibit the disclosure of taxpayer and tax return information. FTB would be required to cooperate with the applicable regulatory organization in any inquiry regarding the penalty with respect to the tax professional.

PROGRAM BACKGROUND

Although there is no precise legal definition of an abusive tax shelter, an abusive tax shelter generally involves a transaction or a series of transactions that on the surface appear to meet the letter of the tax law; however, the underlying transactions lack economic substance and consequently are a sham. The economic substance doctrine (ESD) is a judicially created doctrine and today is elementary to examining the validity of a tax scheme. The ESD states that a transaction, after being stripped of its tax benefits, must have more than a de minimus amount of economic value for the parties to the transaction. This does not mean that tax benefits must be absent from the value of the transaction; however, tax benefits cannot be the principal reason for entering into a transaction.

Most abusive shelters use numerous but purportedly separate transactions to arrive at the desired tax result. Taxpayers create pass-through entities and spread the sham transactions over multiple tax years to complicate the ultimate purpose of the transactions and to impede identification by auditors. Today's shelters are sophisticated to the extent that a highly trained tax professional is required to discover the abusive shelter. A flowchart diagramming a basic abusive tax shelter is attached as Appendix I.

In September 2003, California and other participating states ratified a Memorandum of Agreement (MOA) to share information regarding abusive tax schemes with the IRS and 43 other state and local tax agencies. The MOA streamlines and facilitates the exchange of information among the states, maximizes resources, and prevents duplication of effort. The MOA allows the states to share names of participants in abusive tax schemes, training materials, and other related information. The states share information through a central database that is maintained by New York State.

In addition, FTB participates in:

- Joint Working Groups between the IRS and other states
- Working Groups between the states
- Working Groups between the states and the Multistate Tax Commission
- Working Groups between the states and the Federation of Tax Administrators

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